The Real Estate ANALYST

MARCH 22
1957

Volume XXVI

Number 10

As I see it

HOW GOOD HAS A RESIDENCE BEEN AS AN INFLATION HEDGE ?

SINCE the depression of the 1930's the United States has followed an inflationary policy - first through choice, then through World War II, by necessity, and since then, largely by inertia. A dollar which in 1939 would buy 100¢ worth of commodities and services, will now buy just half that amount, and will only buy one-third of that amount of real estate.

The Administration and the Federal Reserve System are trying to halt the inflationary trends, but inflation has now gone so far and some trends have gained so much momentum that it is proving very difficult to do. No inflation has ever been stopped without hurting various portions of the economy, and if this inflation is stopped, there can be no question that among those hardest hit by the application of the brakes will be those persons connected, either directly or indirectly, with the home building industry. While this is unfortunate, the alternative to stopping inflation is so terrible in its end results that it is better to chance disaster by applying the brakes than to run headlong over the cliff.

In any inflationary trend the person with a fixed income in dollars suffers most. This means that, as a rule, the burden of the inflation falls heaviest on widows and orphans depending on insurance payments, on retired persons living on pensions or on the interest from investments. The speculator fares best, particularly if he is rash and venturesome in his speculations. By buying on margin he can not only conserve his principal but he can increase it many times over, sometimes in a relatively short period.

How has the conservative investor come out in the period we have just come through?

In an attempt to answer this question I have assumed three types of investments which might have been made 16 years ago. The first assumption is that this conservative investor purchased "E" bonds in 1941, the first year in which these bonds were sold. "E" bonds increase in value each 6 months and, therefore, the longer they are held, the greater the redemption value. If held for 10 years, the interest amounts to 3% per year and, if not cashed at maturity, they will continue to draw 3% per year until they are redeemed. The red line on the chart on the following page shows the redemption value, including interest, of an "E" bond bought in 1941, expressed in terms of the 1941 purchasing power of the dollar.

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A Comparison Of Purchasing Power Fluctuations In The Selling Price Of A Typical Residence, Industrial Common Stocks And Government "E" Bonds (1941 - 1957)
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PERCENTAGE ABOVE COST
PERCENTAGE BELOW COST
+110
+100
+90
+80
+70
+60
+50
+40
+30
+20
+10
0
-10
-20
-30
-40
-50
1941
1945
1950
1955
'57
1960
TYPICAL RESIDENCE
INDUSTRIAL COMMON STOCKS
GOVERNMENT "E" BONDS
+89.1
+53.6
-18.5

This would indicate that the person who loaned his Government money in 1941 would have lost 29% of his investment, even when interest was added, had he needed his money in 1948. If he has allowed his "E" bonds to run to the present time, he has still, from the standpoint of purchasing power, paid the Government 18½% to use his money.

The irony of this situation is that, were he to turn in his "E" bonds for redemption at the present time, the Government would tell him that the interest he has earned is equal to half of the purchase price, and would charge him income tax on that amount, in spite of the fact that the total amount he received plus interest would buy 18½% less than his original investment would have bought almost 16 years ago. At no time during the entire period since "E" bonds were first issued could a holder of "E" bonds have put in his bonds for redemption and secured an amount of purchasing power equal to the amount he originally invested. Clearly, "E" bonds, and other investments of that type, have not been good inflation hedges. That is probably the reason why, in the month of February, for example, redemption of savings bonds, of all series, exceeded sales by more than $250 million, a jump of nearly 10 times the figures for February a year ago.

How about good industrial stocks? How have they fared during the same period? The fluctuations of the Dow-Jones industrial stock average, converted to dollars of constant purchasing power, are shown by the blue dashed line on the chart. It will be noticed that an investor in common stocks in the initial part of 1941 would have lost more than one-third of his investment, from the standpoint of purchasing power, had he sold in the spring of 1942. Until the middle of 1945 he would not have been able to sell for an amount equal to his original cost in purchasing power. During the latter part of 1945 and the greater part of 1946 he could have derived more purchasing power from the sale of his stocks than he originally invested, but this situation changed again during the latter part of 1946. During 1947, 1948, 1949, and the early part of 1950, had he sold his stocks, the purchasing power he received would not have equaled the purchasing power he invested in 1941. Subsequent to 1950, stocks would have yielded him an amount of purchasing power in excess of the purchasing power of his original purchase, and from 1954 to the present this excess would be considerable, at one time amounting to a 100% increase over his original investment.

This would indicate that common stocks during this inflationary period, and particularly during the latter part of it, have been a good inflation hedge, with one limitation. Had the investor needed the money that he had invested in any one of 8 of the 16 years covered by the study, he would have had to take a loss in purchasing power had he sold.

The fluctuations in constant dollars of residential real estate from 1941 to the present are shown by the solid blue line on the chart. This line would indicate that an investment made at the beginning of 1941 could have been sold on the market for enough purchasing power to more than repay the original investment at all times during the 16-year period, with the exception of 8 months - 4 in 1941 and 4

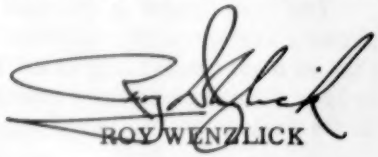
in 1943. At any time since 1946 at least 50% more than the original purchasing power could be secured through sale in all months with the exception of 5 in the latter part of 1947 and 1 in 1948. During a portion of the 16 years, a profit of more than 60% in purchasing power could have been secured. At the present time the property could be liquidated to pay 53.6% more purchasing power than was originally invested.

In computing the industrial stock price line and the real estate line on this chart we have not added to the principal any return on the investment as we have on the "E" bond redemption line. If the dividends that had been paid on the stock could be added to the industrial stock price line and the net income could be accumulated on the real estate line, the tremendous advantages these investments have had over "E" bonds would be still more apparent.

To me, in spite of the fact that in the recent past stocks would have yielded a greater return in purchasing power, real estate, as charted here, has a tremendous advantage for the ordinary investor. In the first place, our chart is based on the selling price of a typical single-family residence, which means that this inflation hedge could have been occupied by the owner as his residence during the period in which he was protecting his capital against inflation. It was not only an inflation-proof investment in the period we have come through, but an investment in living as well. For many families the ownership of their home during this period has been their only inflation hedge.

All lines on this chart have been based on the assumption that the investment made in 1941 was on an all-cash basis. In all probability, however, the investment in a home would have entailed a down payment of only a fraction of the cost of the property at that time. The smaller the percentage paid down and the larger the loan, the greater percentage of increase in purchasing power the average home owner would have received. For instance, if a home owner in 1941 had purchased his home with a 20% down payment in place of all cash, the increase in the purchasing power of his investment would be very much greater than that shown on the chart. Of course, this would also apply to buying industrial common stocks on margin, but the fluctuations of the stock market are so extreme and so unpredictable that, for the safety of the investor, margin buying has been severely restricted. Because of the slow, more predictable changes in real estate, margin buying does not carry the same risk.

While no one can predict the future with certainty, I doubt very seriously whether the long-term inflationary trend can be stopped. I think it entirely probable that during the next few years there may be some halt in the rise, but over a 10- to 15-year period such as shown here, inflation will go considerably further than it has gone to date.



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